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CAN A BANK BE A CONGLOMERATE?

A POSSIBLE STRATEGY FOR BANKS IN THE CHANGING ENVIRONMENTS OF THE UNITED STATES AND JAPAN

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YASUO UMEZAWA

Submitted to the Alfred P. Sloan School of Management
on March 31, 1989

ABSTRACT

The purpose of this study is to clarify the important role of regulations on banks in relation to the public credit system. These regulations are now undergoing a great change, under the recognition that every deregulation should contribute to improve the efficiency of free competition even in the banking system.

For a bank in a free economy to become a conglomerate is an extreme choice. This study hypothesizes that there should be a specific limit for banks to diversify their line of business in relation to the public credit system.

This study analyzes and discusses:

1. The meanings of recent regulations on banks, in both the United States and Japan;

2. The impact of deregulation on bank management;

3. The unique role of the banking industry in the business world; and

4. The possible business diversification for banks to become a conglomerate.

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INTRODUCTION

Under the movement toward deregulation in the United States and in Japan, banks have gradually gained a new flexibility in their management strategy. There were always, of course, many alternatives in their strategy, even under strict regulations, but these were once much more limited than they are today.

In the days of strict regulation, a bank had, in implementing its strategic plan, scrupulously to follow its regulations, carefully avoiding any possible violation. These plans usually contained strategies to pressure the government to relax regulations, in an effort to open opportunities for expanding their business into new and different directions.

As regulations were relaxed widely, banks gained opportunities to add flexibility to their strategic planning. Initially, under the strict regulations, they had simply concentrated their strategy on the banking business. As regulations relaxed, other areas began to attract their interest, areas such as banking-related businesses, other financial businesses, and financially-related businesses: and unrelated business lies just beyond, on the extension of this line.

A bank has long been a corporation doing the business of banking. Though it has dealt with many banking-related businesses, these in the past constituted only a small part of its entire business. However, as banks have, along with the movement of deregulation, gradually diversified their line of business, they are today not always doing banking exclusively. It is not an exaggeration to say that this diversification may herald the separation of banking as a business from the bank as a corporation.

In the past, a "bank" was a corporation which was doing the business of banking, and "banking" was the business that the bank was doing. Though these are arguably tautological definitions, "bank" and "banking" had and still have an inseparable relationship. I have no intention of evolving a linguistic discussion, but one must emphasize that while banking remains a major part of, it is only a part of, the actual business of a bank.

The objectives of a bank to diversify its line of business can be summarized as follows:

(1) To follow up on the needs of customers;

(2) To find new business opportunities; and

(3) To seek economies of scope.

The first objective, to follow up on the needs of customers, is based on a customer-oriented strategy. By observing the customer's needs and providing wide service facilities, a bank can improve customer relations and thus enlarge its business opportunities.

The second objective is to define these new business opportunities. The conventional banking business, described here as "banking," is composed of three principal activities: (i) raising money to lend, (ii) lending money, and (iii) participating in the payment system. As these businesses become stagnant by the development of many other financial facilities and stiff in competition by the entry of other financial institutions, they no longer provide adequate profit. For this reason, banks must seek business opportunities in new arenas.

Banks try, in relation to this objective, to diversify their sources of revenue. Diversification of a bank's asset portfolio is well known as the most useful and effective measure for the reduction of risk. Excessive concentration of the portfolio in one firm or in one industry leads to a

position of vulnerability should the firm or industry come to a serious situation, so are the same as in their sources of revenue. Thanks to the deregulation movement, banks now have the opportunity to adopt this protective measure.

The third objective, economies of scope, is broadly recognized as an important factor of business diversification for individual firms in other industries. In the banking industry, economies of scope are also said to work effectively when they provide their products (and services) jointly through the same window or office. This is certainly a cost-saving mechanism for the customer as well as for the bank itself. The movement of "one-stop" banking or the "financial department store" was on the same line.

Thus product diversification has come to be an important factor in the management of a bank. Diversification has materialized as a financial conglomerate outside the U.S. banking industry. Specifically, a few large firms come to be called a financial conglomerate by holding a bank or banks which are, by the Bank Holding Company Act, legally nonbanks. More deregulation will be expected in the near future which will allow a bank to be a financial conglomerate. These trends may compel bank managers to consider the possibility for a bank to become a (wide-range) conglomerate in planning its long-term strategy.

Every step of deregulation has brought additional flexibility to management strategy, and further steps will bring even more. Although the possibility of a bank's becoming a conglomerate hardly comes to practical issue soon, it is nevertheless useful to examine its possibility. It does, after all, represent the most flexible possibility to the strategy of bank management.

Although in this issue there are many aspects to examine and many possible problems to consider, I will focus on the essential role of banks to maintain the public credit system, or more appropriately, on the role of banking according to my definition. The following issues will be discussed:

1. The recent regulations on banks in the United States;
2. The recent regulations on banks in Japan;
3. The meaning of these regulations for bank management -- advantages and disadvantages;
4. The movement of deregulation and its impact on bank management in the United States;
5. The movement of deregulation and its impact on bank management in Japan;
6. The uniqueness in the business world of the banking industry, and the necessity for a stable public credit system; and
7. The extent of business diversification and the possibility for a bank to become a conglomerate.

1. THE RECENT REGULATION OF BANKS IN THE UNITED STATES

The framework of the modern federal regulation system of banks on the United States was almost entirely established in the 1930s, typically by the Banking Act of 1933, and was presumably completed by the Bank Holding Company Act of 1956. Partial changes were made so frequently during this period that there is no clear overview of the whole of regulations before the great changes of the 1980s. However, the principal regulations are considered here in these five categories:

1. Entry into and exit from the banking industry;

2. Deposit interest rate ceilings;

3. Interstate branch banking;

4. Underwriting corporate bonds and stocks; and

5. Nonbank business ventures.

These do not constitute all categories of banking regulations, but they do cover the most controversial issues that have been argued in Congress, in the courts, and in the business world.

1.1 Entry and Exit

The discussion of the entry-exit issue of an industry generally arouses strong interest, but in U.S. banking there appears to be only marginal interest in this issue. During the five-year period 1979-1983 (Rose, 1987), there existed 1,534 newly-organized banks; 1,199 banks exited (120 insolvencies); and 335 is the net increased number of banks. It thus appears that it was easy to enter into or exit from the banking industry.

It is certain that the basic policy of "free banking" was introduced at the state level in the 1830s, and at the federal level in the 1860s. "Free banking" means that any person, firm, or corporation that meets the required qualifications (e.g. adequate capital) can acquire its banking charter from the authority. Although this policy remains today, there appear now to be some actual entrance barriers to applicants. The level of required qualifications has become too high. Even considering this, it cannot be denied that the U.S. system offers more freedom than that of Japan.

1.2 Deposit Interest Rate Ceilings

Prior to the 1930s there had been no restrictions controlling deposit interest rates. Deposit interest rate control was first introduced

following the Great Depression of the 1930s, by the Banking Acts of 1933 and 1935, in the general belief that excessive competition in the banking industry invited serious catastrophe.

This control was composed of two important parts. (1) No interest was allowed on pay-on-demand deposits. (2) Interest rate ceilings on time and saving deposits were to be set through Regulation Q by the Federal Reserve Board (FRB) or Regulation 329 by the Federal Deposit Insurance Corporation (FDIC) which had been established by the Banking Act of 1933. The practical effect of a ceiling on interest rates had not been apparent before the late 1950s, because until then the actual market rate was never as high as the regulated ceiling. This system prevailed until the deregulation era of the 1980s.

1.3 Interstate Branch Banking

The "unit banking system" prevailed in the United States for a long period, partly because in the early days there was no need for a bank to extend its geographic facilities, and partly because of public fear that large banks might accumulate financial power to possess. There was in the National Bank Act of 1864 no provision delegating to the Office of the Comptroller of the Currency (OCC: now the only body authorized to charter a national bank) authority for branch banking. This authority was given in the McFadden Act of 1927, although it was tightly restricted within each state law. Moreover, because (within the few years following 1927) many states introduced the prohibition, or strict limitation, of branch banking, this activity extending to the remaining states became virtually impossible. Although bank holding companies were exploited as tools of breakthrough for

branch banking, all out-of-state acquisitions of banks by bank holding companies were prohibited by the Bank Holding Company Act of 1956.

1.4 Underwriting Corporate Bonds and Stocks

Another important provision of the Banking Act of 1933, called the Glass-Steagall Act, ruled the separation of commercial and investment banking. The Glass-Steagall Act ruled that (i) no member of a national or state-chartered bank (of the Federal Reserve system) can engage in underwriting corporate stocks and bonds, and (ii) no entity engaged in the business of underwriting stocks or bonds can engage in deposit banking. This Act was established as a result of the experience of the disastrous bank failures of the Great Depression. (The number of insolvent commercial banks stood, in 1933, at over 5,000.) Although it is today considered doubtful that investment banking was the primary cause of these bank failures, at that time it was believed so. And this regulation has survived the deregulation era.

1.5 Nonbank Business Ventures

The principal banking businesses are, as described above: (1) raising money to lend, (2) lending money, and (3) participating in the payment system. The "incidental powers" clause of the Banking Act defines the selected business activities for national banks. Nonbank businesses are also covered by this clause if any business but the principal banking is defined as a nonbank business. Of course these are banking-related businesses, and banks are not allowed to practice other than as defined in this clause.

Other activities through bank holding companies, which once provided "loopholes," are now strictly regulated by the Bank Holding Company Act. Bank holding companies are prohibited from acquiring any voting stock of nonbanking firms, except in those firms whose business is defined by the FRB to be "so closely related to the business of banking or of managing or controlling banks as to be proper incident thereto."

Consequently, as of mid-June 1986 the FRB has already permitted twenty businesses by Regulation Y and twenty-five businesses By Order as permissible nonbanking activities, and twenty-three businesses are listed by Regulation Y as impermissible nonbanking activities (Golembe, 1986).

In addition, the dual banking system complicates the U.S. banking regulation structure. According to this system, any bank is allowed to choose the federal or the state authority as its charter and supervisory office. Also, at the federal level there are three major banking regulators, the FRB, OCC, and FDIC, and none of these has the primary responsibility to supervise all banks of the United States.

The term "Bank" refers generally to commercial banks, but it sometimes includes savings banks. There are other deposit-taking financial institutions: savings and loan associations (S&Ls), and credit unions. And these thrift institutions, savings banks, S&Ls, and credit unions are to appear as rivals of commercial banks in the deregulation era of the 1980s.

2. THE RECENT REGULATIONS ON BANKS IN JAPAN

The modern financial system in Japan originated in the early Meiji era of the 1860s, though the present banking system was completed in the early days following World War II. As the Japanese financial system was almost completely destroyed during World War II, special care and protection were

required for its reconstruction. Consequently, the Japanese Ministry of Finance introduced strict regulation of banks and other financial institutions so that they could watch, protect, and control all institutions in accordance with government policy. The principal categories of banking regulations are as follows:

1. Entry into and exit from the banking industry
2. Deposit interest rate ceilings
3. Separation of domestic from international markets
4. Product segmentation
   (a) separation of long- and short-term businesses
   (b) separation of banking from trust businesses
   (c) separation of banking from securities businesses
5. Secured transaction rule.

Until recently, the Japanese government had remained a comparatively closed system in the financial area. The principal role of financial institutions was to provide enough money for business sectors to grow rapidly. And the most important part of this role was expected to be played by the banking industry. For this reason the industry has long been under strict regulation. I will explain more about each category.

2.1 Entry into and Exit from the Banking Industry

Japanese financial institutions cannot be classified into the same categories as those of the United States. In Japan, Ordinary Banks (City Banks and Regional Banks), Long-term Credit Banks, Trust Banks, and Banks Specialized in Foreign Exchange are to be classified as "banks." *Sogo* Banks (mutual savings and loans), credit associations (*shinyo kinko*), and other deposit-taking institutions are "thrift institutions."

As far as the bank charter is concerned, it had been extremely difficult to obtain from the Ministry of Finance in Japan under the Banking Law. From the mid-1950s to the mid-1980s, virtually no bank was permitted to be established. In addition, newly admitted banks in 1985 were only foreign affiliated Trust Banks. Thus this area has been extremely restricted, as if entry into this industry was most difficult.

2.2 Deposit Interest Rate Ceilings

Prior to World War II, there already existed an interbank agreement on deposit interest rate ceilings which worked as a kind of deposit interest rate control. Following the War, however, the Temporary Interest Rates Adjustment Law was promulgated and the Policy Board of the Bank of Japan was delegated the authority to establish guidelines for deposit interest rate ceilings. Under this Law, the Bank of Japan has also the authority to set up a short-term lending rate ceiling, called the short-term prime lending rate. Each of these rates is a kind of guideline, with no legal coercive power. However, they have been used as each bank's own guideline, as if they in fact carried such legal power.

2.3 Separation of Domestic and International Markets

The Foreign Exchange and Foreign Trade Control Law was newly-established in 1949. It was at first such a strict regulation so as to prohibit almost all overseas transactions except those permitted by the government or by ministerial ordinances. Although this regulation has, along with the movement of international liberalization, gradually been relaxed, strict foreign exchange control disappeared only in the 1980s.

This regulation had worked virtually and effectively as a device of segmentation between domestic and international markets. Consequently domestic banks in Japan were protected from intensive competition with financial institutions overseas, and the strict Japanese regulation system was maintained until the 1980s.

2.4 Product Segmentation

The most distinctive feature of regulations on Japanese banks is product segmentation; it produced the so-called specialized financial institution system. Japanese banks are classified as follows: Ordinary Banks, specializing mainly in short-term business; Long-term Credit Banks in long-term business; Trust Banks in trust (and long-term) business; and the Bank of Tokyo, specializing in foreign exchange business. There are, in addition, specialized financial institutions, such as those specializing in small business finance (e.g. *Sogo* Banks, credit associations) and in finance for agriculture, forestry, or fishing.

The separation of long-term and short-term business is the most fundamental regulation within product segmentation. The basic idea of separation originated more than 100 years ago when modern Japanese banking was introduced from Great Britain by the Meiji government; this was accompanied by the commercial banking (or "real bank") doctrine, which specified that commercial banks must concentrate on short-term business due to their short-term fund base. This idea was retained, under the guidance of the U.S., during the post-World War II reconstruction of the Japanese financial system. In 1952, Long-term Credit Banks were established and Trust Banks given the power, by the Loan Trust Law, of a long-term fund raising facility.

Owing to this framework, many administrative guidances have been suggested by the Ministry of Finance, and Long-term Credit Banks and Trust Banks have developed into quite different types from City Banks, focusing mainly on long-term financial businesses.

The separation of banking from the trust business was based on the theory of "conflict of interest." However, as Trust Banks have developed into a comparatively similar type of Long-term Credit Bank, this regulation has also been recognized as one of separation of long- and short-term businesses.

Before World War II, a rule already had existed separating banking from securities businesses. Following the War, this separation was formally adopted into the Securities and Exchange Law, which was based on the U.S. Securities and Exchange Act of 1934. The spirit of the Glass-Steagall Act was transplanted into Article 65 of this Law.

2.5 Secured Transaction Rule

It is a generally recognized practice in Japan that principal financial transactions such as bond issuings, bank lendings, and interbank transactions must be secured. Although this general rule was established prior to World War II, it has been gradually strengthened and still functions today as a kind of regulation.

I will discuss a few points in relation to U.S. regulations.

First, as Japan is not so large a country as the U.S., there is no Japanese regulation like the U.S. interstate one. However, branch banking requires permission of the Ministry of Finance, and this permission is difficult to obtain. It is called the Branching Administration, and the

business area of each bank has been allocated carefully through this measure.

Second, there is in Japan no bank holding company. Following World War II, *Zaibatsu* (financial cliques) were dissolved and the Law Concerning Prohibition of Private Monopoly and Security of Fair Trading was established, modeled after the U.S. Antitrust Law. However, as it was based on American idealism at that time, it leaves no room for the possibility of establishing a bank holding company.

Third, there are in Japan two regulators of banks: the Ministry of Finance, and the Bank of Japan. The former has the chartering authority, supervising and administrating each bank, and the latter monitors the behavior of each bank and plays the important role of lender of last resort.

3. THE MEANING OF THESE REGULATIONS FOR BANK MANAGEMENT -- ADVANTAGES AND DISADVANTAGES

The history of U.S. banking regulations can be described as one of conflict and balance between competitiveness and soundness of the banking industry. The strong demand in the 1860s for competitiveness led to the establishment of the so-called "free" banking system on the state and federal levels. Public fear of concentration of banking power as well as a hostility to banks because in those days they provided very little convenience to the public, provided grounds for the introduction of interstate branch banking regulations.

And also the restraint of banks from free nonbank business ventures was based on the fear of financial concentration as well as on the conviction

that banking should be separated from commerce. These ideas produced the separation of commercial from investment banking, in the turbulent 1930s.

The regulation of deposit interest rate ceilings clearly intended that banks should not engage in excessive competition in deposit-taking by providing excessively high interest rates. It was generally believed that the excessive competition in high interest rates was the most crucial reason for the bank failures of the 1930s.

Thus U.S. regulations on banks were established with this social and historical background. These regulations had certainly provided banks with some limited business opportunities, enough to make a certain profit in these regulated areas but not enough to satisfy their greed. There were definite barriers against their expansion, but not against their viability.

From a different point of view it can be said that each individual bank had been protected from competitors. The regulations on interstate banking activities had worked as the protector for medium- and small-sized banks and for thrift institutions, from the erosions of big banks based in other states. Moreover the regulation of deposit interest rate ceilings was virtually a kind of buying price cartel so that every bank (and thrift institution) could save its cost effectively.

These regulations had deprived banks of their strategic management flexibility, but at the same time they had worked as the system that provided to banks a less competitive environment so that they could be managed safely and soundly. Practically speaking, the number of bank failures was kept in single digits for the three decades following World War II.

On the other hand, of the history of Japanese banking regulations it can be said that, first comes the regulation and then the banking business

follows. The principal role of Japanese financial institutions for the few decades after World War II was to provide enough money for the business sector to reconstruct itself and to grow rapidly. As the reconstruction of financial systems was also required at that time, there was almost no room for free competition among banks and other financial institutions.

The Japanese government was required to establish a new and efficient financial system, strong enough to help to reconstruct the whole industry which had been almost completely destroyed in the War. For this purpose, the specialized financial institution system, the most distinctive feature of the Japanese financial system, was established by the government and has until recently worked effectively.

Japanese deposit-taking institutions have been classified into four main specialized categories: (1) short-term banking, (2) long-term banking, (3) long-term banking and trust business, and (4) small- and medium-sized financial business. In addition there had been the separation of domestic from international markets, and strict entry regulations.

Thus, the Japanese banks were separated into these categories based on their specialized financial functions. Therefore, the primary competitors of each bank had been other banks of the same category, So, most of the bank management in those days had focused on their competitors of the same category. And they had been required to take only a little responsibility for other competitors, for the time being.

As the Japanese securities market had not yet matured before the 1970s, securities houses had not appeared as the important rivals of banks. Even among banking institutions, they had shared their banking business along with their specialized functions, such as short- and long-term lending.

As this specialized financial institution system was completed in the mid-1950s and had been minutely arranged, bank managers now devoted all their energies to business expansion within the area permitted by the regulations rather than to searching for loopholes for new business opportunities.

The minute regulations system, and the severe scrutiny of the Ministry of Finance and the Bank of Japan, seemed to have kept almost all banks free from failure. There was almost no room for banks to enter into risk-taking business outside banking.

4. THE DEREGULATION MOVEMENT IN THE UNITED STATES AND ITS IMPACT ON BANK MANAGEMENT

The deregulation of U.S. banks began in the mid-1960s, accelerated through the late 1970s, and has culminated in the deregulation era of the 1980s. The reason for these movements are said to be (a) inflation and high and volatile interest rates, (b) the appearance of powerful institutional investors such as pensions funds, and (c) technological innovation of computer and communication systems.

These movements are not simple but they can be summarized by these four items:

1. The abolition of deposit interest rate ceilings;
2. The homogenized business capabilities of nonbank thrift institutions with commercial banks;
3. The relaxation of interstate banking restrictions; and
4. The entry of nonbank industries into banking businesses.

4.1 The Abolition of Deposit Interest Rate Ceilings

Although ceilings had been pushed up since the mid-1960s, along with the rising market interest rate, they hardly reached levels that would attract depositors, and there occurred the so-called "disintermediation." Therefore various measures were introduced to support the fund-raising capabilities of financial institutions, e.g., the suspension of deposit rate ceilings for certificates of deposit (CDs) of $100,000 and more in 1970, and the permission of negotiable order of withdrawal accounts (NOWs) in 1974 in a few states.

However, all deposit interest rate controls were finally to be abolished by 1986 by the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMC), except that NOWs are limited to individuals and no interest is allowed for demand deposits.

4.2 The Homogenized Business Capabilities of Nonbank Thrift Institutions with Commercial Banks

From the beginning, nonbank thrift institutions had limited their lending activities. Savings banks and S&Ls specialized primarily in mortgage loans, and credit unions were in consumer loans. However, as the deregulations of their liability side could not reduce their financial predicament, their asset-side activities were also expanded by DIDMC and the Garn-St Germain Depository Institutions Act of 1982. Consequently, they now have almost the same business facilities as do commercial banks.

4.3 The Relaxation of Interstate Banking Restrictions

Interstate banking had, in the 1980s, gradually materialized through the exception clause of the Douglas Amendment (the Bank Holding Company Act

of 1956), which allows mergers and acquisitions by out-of-state bank holding companies only as a relief measure. In addition, each state was required to give certain nationwide facilities to its own state banks because their competitors for fund raising had been other nationwide firms in addition to other banks.

Therefore, each state had established some kind of interstate banking law, and as of September 1986 (Mabuchi, 1988) 41 states had adopted such a law, although some are so-called regional banking statues and some contain a reciprocity clause.

4.4 The Entry of Nonbank Industries into Banking Businesses

As early as 1970 there already existed a loophole that nonbank industries were exploiting for their entry into the banking business in the 1980s. In the Bank Holding Company Act of 1970, the "bank" was defined as an institution of (1) accepting demand deposits, and (2) making commercial loans. The lack of either of these functions defined the bank as a "nonbank."

NOW accounts have been introduced as the substitute measure of demand deposits, and the commercial papers as that of commercial loans. In the 1980s, nonbank banks which were not "banks" because of their lack of one of these two functions could engage in the same businesses as genuine banks. These measures were utilized by other industries for entering into the banking business, as well as by bank holding companies for their interstate banking activities. Although this loophole has been closed by the Competitive Equality Banking Act of 1987, many nonbank firms remain holding a bank or banks under their management.

These deregulations have greatly influenced financial institutions. However, as the transition is ongoing and any clear design of the new financial system has not yet shown up, it is difficult to describe exactly the whole influence of deregulation. Also, the direction and speed of deregulation are not stable.

The influences up to present on financial institutions can be defined as follows. First, the profitability of (conventional) banking businesses become unstable because many powerful firms of other industries have entered into banking businesses, and because many useful banking-like products have been introduced so that banks face high competition both inside and outside the banking industry.

Second, as a consequence of deregulation, larger banks are interested in diversifying their line of business and extending their geographical activities, and small- and medium-sized banks appear to seek super regional or boutique banking, but some are already in difficulty (such as many S&Ls).

Third, deregulation has increasingly blurred the distinction between commerce and banking, which distinction most lawmakers had great effort to keep clear. This segmentation has been the great support for public desire to prevent banks from acquiring excessive power through their concentration.

Fourth, the new regulation framework has begun to be sought on the recognition that the old regulation system has been unfit for the recent financial system. In addition, the new framework is considered to regulate not institutions but their functions. This directions seems to accelerate the separation of banks from banking.

Fifth, as the number of insolvencies has increased through the process of deregulation, all regulatory systems have been reconsidered along with the re-examination of the deposit insurance system. Re-regulation may be

expected when measures other than that of strengthening the deposit insurance system are sought.

5. DEREGULATION AND ITS IMPACT ON BANK MANAGEMENT IN JAPAN

Deregulation of banks was begun in Japan in the early 1970s, a few years later than in the U.S. Deregulation has been realized at a more moderate pace than in the U.S., and is still ongoing.

The reasons for this movement in Japan are as follows, in part similar and in part different from those in the U.S.

(a) The rapid growth of international transactions;

(b) The development of non-regulated money market through a large-scale issue of government bonds;

(c) High and volatile interest rates due to worldwide inflation from 1973; and

(d) The remarkable progress of technology in computer and communication systems.

The oil crisis of 1973 propelled Japan from high economic growth into a new economic stage, and created a dramatic change in financial environment. Compared to the U.S., deregulation of the Japanese financial system has just begun, and has made unremarkable but steady progress. The movement can be summarized as follows:

(1) Partial relaxation of entry regulations;

(2) Remarkable progress toward the abolition of deposit interest rate ceilings;

(3) Abolition of market separation, domestic and international;

(4) Partial relaxation of product segmentations; and

(5) Partial relaxation of secured transaction rule.

These factors have been under the strong influence of the U.S. deregulation movement. As the Japanese financial system has been strictly regulated for a long time, these movements are often called not deregulation but liberalization. I will enlarge on each item.

5.1 Partial Relaxation of Entry Regulations

Although no new chartered banks were established after 1954, nine foreign-based Trust Banks were permitted to be established in 1985, after almost thirty years' blank. However, this fact does not represent complete relaxation of entry control, and there seems to be little consideration of the efficiency of competitiveness in banking entry controls.

5.2 Remarkable Progress in the Abolition of Deposit Interest Rate Ceilings

The regulation of deposit interest rates has been gradually liberalized in such areas as the 1979 introduction of Negotiable Certificates of Deposit (CDs), Money Market Certificates of Deposit (MMCs) in 1985, and the 1985 abolition of large-scale time deposit interest rate ceilings.

The abolition of whole-time deposit interest rate ceilings have recently fallen under the consideration of Japanese authorities. The 1987 repeal of the Tax-exempt System of Small Savings played an important role in leveling the competing field, mainly between private banks and Postal Savings, the largest deposit-taking institutions in the world.

5.3 Abolition of Market Separation, Domestic and International

After the oil crisis of 1973, the floating exchange rate system for the U.S. dollar was adopted. It has contributed to relax the strict foreign exchange control. In addition, the accumulation of trade surplus and the

rapid growth of international transactions have accelerated the relaxation of the market separation policy.

At last, the principal policy of the Foreign Exchange and Foreign Trade Control Law was in 1980 fully changed from "prohibit" to "free" -- and thus Japan rose beyond the position of a less-advanced country.

5.4 Partial Relaxation of Product Segmentation

The relaxation of separation of banking from securities businesses has made a little progress, so that in 1984 banks were authorized to conduct business on public bond dealings and over-the-counter sales of government bonds. At the same time, securities houses were approved to deal with the government bond investment fund with checking functions. However, full relaxation seems to be next to the amendment of the U.S. Glass-Steagall Act of 1933.

The other product segmentations still remain through the specialized financial institution system, although in February 1989 more than half the *Sogo* Banks changed their position to become a member of Regional Banks. These product segmentations are now under the careful examination of the Financial System Research Council of the Ministry of Finance.

5.5 Partial Relaxation of Secured Transaction Rules

The secured transaction rules have also loosened, relaxing the issuing limit on unsecured bonds and the introduction of unsecured call money transactions, theretofore not permitted. These rules are business practices that are peculiar to Japan; they apparently will be abolished in the near future, along with the expansion of international transactions.

These regulation systems have certainly worked well enough to achieve the goals of the government as well as of the banking industry. Even if the system were almost closed so that there were only a few cases of entry into and retirement from the banking industry in these decades, this very fact helped the banking system to be stable and secure enough to support the economic expansion of Japan.

However, the business environment of financial institutions has changed dramatically. Banks and other financial institutions must prepare for a new business framework which is not, so far, clear to them, and they are undergoing a great transition.

Under the strict regulations, banks competed only with other banks of their same category. They were carefully protected from the threat, not only of other industries, but from banks of other categories. Even had they competed with each other, and actually they did very hard, it was only a battle in a teacup.

On the contrary, liberalization makes them face stiff competition on the one hand, both inside and outside, and on the other hand it offers many business opportunities. It also exposes them to unexperienced risks, and hard competition necessarily increases chances of risk.

Strict restriction has deprived Japanese banks of learning free market discipline, but they must learn it now. The strict regulations played a role in protecting and nurturing banks, as well as in maintaining a secure and sound public credit system. Banks now must seek new discipline, while struggling to survive through severe competition.

6. THE UNIQUENESS OF THE BANKING INDUSTRY IN THE BUSINESS WORLD AND THE NECESSITY FOR A STABLE PUBLIC CREDIT SYSTEM

Regulations on banks in the past, and the present deregulation movement in the U.S. and Japan, are discussed above. Here I examine the fundamental reasons why banking regulations were necessary, and the basic issues of whether they remain necessary. Because banks play a special role in the business world, certain regulations must be necessary for banks both in the U.S. and in Japan.

For this purpose I will discuss next a few items, as follows:

(1) The role of banks in the economic system;

(2) The necessity for regulations on banks;

(3) The impact of deregulation upon the financial system; and

(4) Possible alternatives to old regulations.

6.1 The Role of Banks in the Economic System

The principal functions of a bank are, as defined above, these three: (1) raising money to lend, (2) lending money, and (3) participating in the payment system. Through these first two functions, banks play the important role of financial intermediary, which helps the need of surplus unit (savers) with the need for deficit unit (investors).

The function of credit creation is the second important role of a bank, and for this reason a bank is called a "special" intermediary. When a bank lends money, it pays it in the debtor's deposit account. As this deposit is not always drawn out soon, the bank can lend money to others depending on this deposit and pays it in the other debtor's deposit account.

Accumulating this chain of actions, the bank acquires a large amount of loans on the one hand and a small amount of cash reserves on the other.

This fact that a bank can lend an amount of money in excess to its cash reserves is called "creation of credit." And this role is played through all three principal functions of a bank.

As the creation of credit works as leverage over extending banking business, a bank requires only a small amount of money, enough to meet the cash demand of depositors. This system gives a bank great efficiency as well as a kind of vulnerability, because every bank depends fully on the confidence of its depositors.

Once this confidence collapses for some reason, there will be a run on many banks, and financial crisis will result. The financial crisis brings on various phenomena, such as (1) discontinuity of intermediary, (2) sharp shrinkage of money supply, and (3) dysfunction of the nationwide payment system. In short, banks support the monetary system of their country, which is the most important infrastructure of their economic system.

6.2 The Necessity for Regulations on Banks

When banks are recognized to play an indispensable role in the economic system, it is necessary for their society to maintain this indispensible role of banks. For this purpose, the confidence of depositors must never collapse, and public credit systems should be maintained.

There are four credit control combinations, according to the differences in the method of control, prior or post, and public or private, as shown in the Table (next page). Regulation is classified prior public control (type A), and deposit insurance system is classified post public control (type B). On the other hand, prior private control (type C) includes market discipline or self-restrictions of its industry, and post private (type D) includes a mutual aid system.

Table

	Public Control	Private Control (Market)
Prior Control	(A) Limited Competition Regulations Balance Sheet Controls	(C) Market Discipline Self-restriction of the Industry
Post Measure	(B) Deposit Insurance System Authorities' Assistances Lender of Last Resort	(D) Mutual Aid System

Source: Horiuchi, 1983.

The mixed type of A and B was adopted in the U.S. in the early 1930s, whereas Japan was fully dependent on type A. Although the deposit insurance system was introduced in Japan in 1971, there has so far been no payment of insurance claim. These may be the result of their different objectives. The U.S. objectives of regulations on banks (Litan, 1987) are said to be mainly (1) to keep the banking and monetary system safe and sound, (2) to ensure allocating funds in fair, and (3) to prevent banks from concentrating their power more than expected or feared. The separation of banking and commerce is related to all these items.

On the other hand, the Japanese objective has long been simple, principally to keep the banking and monetary system safe and sound so that they can bring up the entire banking system and enable banks to provide enough money for other growing industries. The lack of mature securities market had especially burdened heavily the shoulder of the banking industry as a financial intermediary.

The regulations on banks had long been expected to play at least the role of maintaining the banking system safely and soundly, in both the U.S. and Japan.

6.3 The Impact of Deregulation upon the Financial System

After the 1970s, various factor appeared in both the U.S. and Japan, which had a great impact on the banking system, such as (1) high and volatile interest rate of market, (2) banking-like services through technological innovations in computer and communications, and (3) easy access facilities to international markets.

These factors created strong rivals outside the banking industry, rivals that banks could not effectively compete with due to their strict

regulations. Therefore, the regulations which should have kept banks save and sound, on the contrary, were to put them in danger.

Thus the deregulation movement started. This was not the revision but the abolition of regulations on banks. Because the environment of the banking business has changed too rapidly and too broadly for the government or authorities to cope with, the banking industry as well as other industries was to be left to the market mechanism. However, they are not always left in the free market process. No credit control is not expected, but some of the prior public controls are expected to resign their position. Banks are still undergoing a transition, and there is, so far, no reliable view of their future.

As the result of deregulation, banks are trying to diversity their line of business so that they can survive the stiff competition, and nonbank firms are seeking ways to enter the banking business. Thus the distinction between banks and nonbank firms becomes more blurred than ever.

6.4 Possible Alternatives for Old Regulations

Regulation as a credit control is classified prior public control (type A), as discussed above. When the role of type A is lowered in the area of credit control, the other single or mixed types should be considered for maintaining a public credit system.

Here the deposit insurance system is given great attention as one of type B (post public controls). Although this system is said to have worked effectively in the U.S., there are some problems with it. The first is the so-called "moral hazard." In the deposit insurance system, a certain amount of deposits ($100,000 in the U.S., ¥10M in Japan) are guaranteed to be repaid by the insurance corporation. Ironically, this allows bankers to do

riskier but possibly more profitable business without bearing any risk of a run. In other words, the deposit insurance system creates a possible moral hazard. The recent political issues of S&Ls seem to belong almost to this category.

A second problem in the deposit insurance system lies the "too large to fail" issue. As a failure of a large bank has great influence on the national economy, large banks are not to be liquidated but are to be allowed to survive through the means of "purchase and assumption" or "deposit assumption." This means that not only small deposits but also larger deposits of more than $100,000 are to be equally secured. Therefore all depositors of large banks are virtually protected by the insurance corporation.

Thus the more effectively this system works, the less efficiently the prior private control (type C) system works. As no effective measure is found in the type D, the mix of types B and C or types B and A (the different type of regulation, e.g. balance sheet control) seems to be an alternative to old regulation.

In the case of mixed type B-C, such issues must be considered as how to form the market discipline and how to control the moral hazard issue. In the case of type A-B, on the other hand, the contents and the form of regulations should be examined. The issue of the form means that the object of regulation should not be a bank as an institution as with former regulations, but banking as a function.

The old regulations had certainly worked effectively, both in the U.S. and in Japan, as a measure for maintaining the public credit system in a safe and sound condition. However, as the environment of financial

institutions has changed dramatically, it has become clear that the old regulations cannot keep up with these changes.

A new framework is needed to respond to new circumstances and to meet demands such that (1) free competition is necessary for the efficiency of the financial system, (2) the public credit system should be maintained in safe and sound condition, and (3) this framework must keep up with the present and future changes of the financial environment.

Old regulations such as business controls which worked to respond to demand (2) will fade away, because they can no longer meet demands (1) or (3). Here is the great possibility for banks to diversify their line of business, not only inside the financial area but also outside, to much broader business areas.

However, it is most important that demand (2) be met. The deposit insurance system is fit to this purpose, but it is clear that it has a certain limit in contributing to market efficiency. When a certain alternative measure cannot be found, regulations of prior public control type may be strengthened and heavily relied upon again.

One more important measure if type B is the role of the central bank, the "lender of last resort." This measure plays the role of covering the weak point of credit creation in the banking system. This works only when a bank is in liquidity trouble. It has a very effective and important function, although quite limited, and works only when the whole banking system is considered to be exposed to serious danger.

7. THE EXTENT OF A BANK'S BUSINESS DIVERSIFICATION AND THE POSSIBILITY FOR A BANK TO BECOME A CONGLOMERATE

Banks have been not only controlled but also protected by the strict regulations. It is certain that banks were given very little flexibility to extend their business inside and outside the banking industry. At the same time, the regulations prevented banks from excessive competition in order to help them to make a certain profit in their business.

Deregulation, the relaxation or abolishment of these regulations, have on the contrary made banks not only to gain various kinds of flexibility in their business expansion, but also to be able to face stiff competition, inside and out. As a result, banks receive much flexibility in exchange for protection.

Consequently, banks become more eager than ever to diversify their line of business. They will take every opportunity to diversify their business both at home and abroad. In the extent of this diversification lies the possibility to become a conglomerate. However, there are of course many obstacles to a bank's becoming a conglomerate.

One of the most important issues is the necessity for a stable public credit system, because the public credit system must require a certain degree of controls on banking activities in order to keep it safe and sound. I will enlarge on these issues along with the next items, as follows.

(1) The necessity for business diversification;

(2) Many obstacles to becoming a conglomerate;

(3) The necessity for a stable public credit system; and

(4) The possibility to become a conglomerate.

7.1 The Necessity for Business Diversification

As banking businesses depend fully on the confidence of their depositors, banks have placed great emphasis on keeping their earnings stable. Under previous controls of deposit rate ceilings, both stable fund sources and excellent quality loan portfolios had done well enough to provide them a stable profit base.

However, the business environment has changed dramatically. As the result of deregulation, banks have come to compete severely with each other, in both fund raising and lending activities. In addition, the advent of new rivals from other industries has keenly intensified their competition. The stiff competition usually brings in less profitable conditions, and it is not the exception this time.

Consequently, banks are obliged to find other and more profitable business opportunities, and this is one of the most important reasons that they are trying to diversify their line of business. Of course, most bankers, as entrepreneurs, may take these opportunities for business expansion.

Basically, bankers have plenty of experience to recognize the merit of diversification through the lending business. As any individual firm has some uncertainty for its future, the lending to this firm carries a certain risk. Banks have therefor diversified their asset allocations in order to minimize their possible loan losses in these lending activities.

It is necessary and natural for banks to strive to diversify their line of business under circumstances in which they are no longer protected by regulations (or by the government). The deregulation movement has stimulated banks to support themselves, and banks must secure their stable

profits by themselves in such stiff competition in order to keep the confidence of their depositors.

7.2 The Many Obstacles to Becoming a Conglomerate

Although many obstacles must be considered in order for a bank to become a conglomerate, the largest obstacle in the U.S. seems to be the strong belief, supported by many people, that banking should remain separate from commerce. The Glass-Steagall Act was the product of this belief. Whereas in other industries some firms have already materialized to become a conglomerate that includes banking functions, banks themselves are prevented because of this belief.

Until the Glass-Steagall Act is lifted, it remains difficult for a bank to be even a financial conglomerate. Banks are not permitted to hold in their investment portfolio any share of stocks but securities, only "in the form of bonds, notes, and/or debentures."

When the Common Market is established throughout Europe, and it is planned for 1992, Congress will be obliged to revise this Act in order to respond to the reciprocal requirement and to level the battlefield between U.S. and European banks. And the discussion on this has already started, inside and outside Congress.

On the other hand, the largest obstacle in Japan is the Anti-Trust Law, the Law Concerning Prohibition of Private Monopoly and Security of Fair Trading. Article 11 of this law shows that no financial institutions are allowed to hold in excess of a 5 percent share of stocks issued by each domestic corporation. And there is not, in Japan, a Bank Holding Company Act similar to that in the U.S.

Article 65 of the Securities and Exchange Law, which is based on the Glass-Steagall Act, is under examination by the Japanese government, as if it kept step with the U.S. And the bank holding company measure, as in the U.S., seems most likely to be adopted in the revision of this Article in the near future.

Another important obstacle in Japan may be the image of *zaibatsu* (a financial clique). Although major groups of *zaibatsu* were almost completely dissolved just after World War II, the bad image still remains in the memories of the Japanese as a symbol of the *ancien-règime* of militarism. The potential and instinctive public fears of business concentration are not against banks, as in the U.S., but against *zaibatsu*.

Although there are many obstacles, the most important obstacle to a bank's becoming a conglomerate, in both the U.S. and Japan, is the role banks play in the public credit system. Because, as discussed above, the whole economic system needs always the stable public credit system, and the principal part of this system has been played by banks.

7.3 The Necessity for a Stable Public Credit System

Although banks had already started diversifying their line of business before they entered into the deregulation era, and they have gradually shifted the weight of conventional banking business to other parts, banking and the function of credit creation still remain the principal emphasis of banks.

In other words, because banks function to create credit, they are not allowed to diversify their line of business beyond a certain limit. Such high-risk business ventures, although they are expected to bring high

returns, seem to place banks in greater danger, and even to trigger the financial uncertainty of the whole economy.

Banks have the special feature that the failure of one always brings about the failure of another, and so on, according to their chain of credit creations. Of course the actual mutual transactions are cause of this phenomenon. Moreover, the loss of public confidence in the banking system can trigger financial uncertainty and cause a run.

This is why every government of a free nation has paid close attention to this feature, and they have long controlled and protected their banks. This important role of banks in the public credit system has not yet changed through the deregulation movement, and will not change in the future so long as banks play the role of credit creation. Therefore, banks seem to face great difficulties in broadly diversifying their line of business, unless conventional banking businesses stay on in a major position.

7.4 The Possibility of Becoming a Conglomerate

Banks in both the U.S. and Japan have extended their business abroad along with the globalization movement, taking advantage of new business opportunities. This new internationalization has brought with it a detour of their domestic regulations, and they have already done a kind of "universal banking" in Europe, which includes both commercial and investment banking.

Once banks have recognized the advantages of business diversification through international business activities, they become more and more eager to seek opportunities for diversification. However, if bankers have in mind an image of a broad-range conglomerate, they must first of all strive to make up a financial conglomerate.

In order to protect the public credit system, the banking business should not be exposed to the risks of new business ventures; therefore a certain segmentation between banking and other businesses seems to be required. Although it is convenient for affiliated companies to utilize the banking function of the same group, these transactions should lead to the bank's direct involvement in the other nonbank company's risks.

Of course, any structure of conglomerate, including that of a bank, may be possible, if a certain degree of oligopoly is allowed and the banking function is protected at all times by the government. But this goes against the spirit of free competition under which management of the company is considered to work most efficiently.

Under the framework of a free economy, it will be a long time before a conglomerate, including banking function, is allowed to be established. When more banking-like products are developed and the role of banking in the whole economy becomes less important than today, it will become easier for a bank to become a conglomerate. Until then, banks will continue to diversify their lines of business by means of trial-and-error.

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